

## Module A

### Introduction to Tax-Exempt Bonds

#### Overview

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**Introduction** This module provides an introduction to the municipal (tax-exempt) bond market. It is divided into five sections.

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**Contents** This module contains the following topics:

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**Objectives** At the end of this module, the student will be able to:

- List and define the various types of bonds.
  - Identify and explain the role of the parties involved in a municipal bond financing arrangement.
  - Identify serial bonds and term bonds.
  - Distinguish between fixed and variable rate bonds.
  - Explain the rate setting procedure for variable rate bonds.
  - Identify the basic bond documents.
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## Overview, Continued

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<b>Fundamentals</b>	The basic concepts and terminology presented in Module A serve as a foundation for the rest of the course. Your understanding of these fundamentals is essential for your success in the class. Therefore, if you have any questions, be sure to raise them in class.
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<b>Tax Laws</b>	Module A is the only module in the text that does NOT specifically address the federal tax laws pertaining to municipal bonds. These laws are introduced in Module B, and then detailed in the rest of the course.
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# Section 1

## History of Municipal Bonds

### Supreme Court Decisions

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#### Introduction

The Supreme Court first considered exemption of the interest on state and local obligations (“municipal bonds”) in 1895. The Court held in Pollock v Farmers’ Loan & Trust Company, 157 US 429 (1895), that the federal government had no power under the Constitution to tax interest on municipal bonds.

The Sixteenth Amendment was codified in the Revenue Act of 1913 to provide for the exemption of interest on State and Local Bonds.

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#### South Carolina v Baker

Before July 1, 1983, municipal bonds could be in bearer form and have interest coupons attached to them. In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act. Under this Act, to be exempt from federal tax, bonds are required to be registered.

In South Carolina v Baker, 485 US 505, 1988, South Carolina challenged this requirement on constitutional grounds. The Supreme Court upheld the registration requirement.

In South Carolina v Baker, the Court also stated that Congress could tax interest income on municipal bonds if it so desired. Tax exemption of municipal bonds is therefore, not protected by the US Constitution.

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## Statutory History

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<b>Revenue Act of 1913</b>	<p>The Revenue Act of 1913 first codified exemption of interest on municipal bonds from federal income tax.</p> <p>Section 103(a) of the Internal Revenue Code of 1954 excluded interest on municipal bonds from federal income tax. In the 1954 Code, only IRC § 103 dealt with qualification requirements for municipal bonds of all types.</p>
<b>Tax Reform Act of 1986</b>	<p>The TRA 1986 greatly reduced private activities that may be financed with tax-exempt bond proceeds. It also required that municipal bonds must meet certain additional rules for the interest received by the bondholders to be exempt from federal income tax.</p> <p>IRC § 103(a) is the statutory provision that excludes interest on municipal bonds from federal income tax. However, other rules such as those pertaining to private activity bonds, arbitrage, and hedge bonds are found in sections 141-150, 1394, 1400 and 7871.</p>

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## Section 2

### Types of Bonds

#### Overview

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**Introduction** Municipal bonds may be issued as governmental bonds or nongovernmental bonds. Nongovernmental bonds are also called “private activity bonds.”

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**Contents** This section contains the following topics:

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**Governmental Bonds** Governmental bonds are issued to finance activities owned and operated by a state or local government. Some examples are:

- courthouses,
  - highways,
  - governmental office buildings, AND
  - sewer and water facilities.
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**Private Activity Bonds** Private activity bonds may be issued for the limited purposes specified in IRC §§ 142(a), 143, 144, 145, 1394, and 7871(c)(3). Except for qualified small issue bonds issued by Indian tribal governments under section 7871(c)(3), the facilities financed with proceeds of private activity bonds can be owned and operated by nongovernmental entities.

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## Overview, Continued

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**Pooled  
Financings**

A third type of bond is called a pooled financing. Pooled financings may involve proceeds of governmental bonds or certain types of private activity bonds.

Each of these types of bonds is identified in this section. As the course progresses, you will learn much more about all of these bonds.

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# Governmental Bonds

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<b>Introduction</b>	<p>Governmental bonds are issued to finance typical governmental functions of a state or local government. Some examples are:</p> <ul style="list-style-type: none"><li>• roads,</li><li>• sewer and water systems,</li><li>• convention centers, AND</li><li>• other governmental buildings.</li></ul>
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<b>Classifications for Tax Purposes</b>	<p>For tax purposes, we classify municipal bonds as:</p> <ul style="list-style-type: none"><li>• tax-exempt (governmental or qualified private activity bonds), OR</li><li>• taxable (private activity bonds).</li></ul>
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<b>Classifications for Municipal Financial Purposes</b>	<p>Municipalities, however, classify their bonds even further depending on:</p> <ul style="list-style-type: none"><li>• the funding source used to pay the bondholders (i.e. general obligation bonds, special assessment bonds, revenue bonds) OR</li><li>• the short-term nature of the bonds (i.e. Bond Anticipation Notes, or Tax Revenue Anticipation Notes).</li></ul>
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Municipalities classify their bonds like this to facilitate their fund accounting systems.

The information in this section will familiarize you with these types of bonds.

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<b>General Obligation Bonds</b>	<p>Principal and interest payments on general obligation bonds (“GO bonds”) are secured by the full faith and credit and taxing powers of the bond issuer. The GO bond issuer has the authority to levy and collect taxes.</p>
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GO bonds are generally not secured by a mortgage on any particular property. If the issuer defaults on its obligation to pay debt service on GO bonds, the bondholders have the right to go to court to compel the issuer to raise taxes sufficient to pay debt service on the bonds.

In certain cases, the issuer may agree to pay debt service on the bonds from specific taxes.

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## Governmental Bonds, Continued

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**Example 1** Assume that sales taxes on alcoholic beverages are to be used to pay debt service on bonds issued to finance a civic center. Because the bonds are secured by a specific tax and NOT by the general taxing power of the issuer, the bonds are NOT general obligation bonds.

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**Revenue Bonds** Principal and interest payments on revenue bonds, are secured by, the revenues received from a specific course. Generally, the source of revenues is the facility financed with the proceeds of the bonds.

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**Example 2** City X issues bonds and uses the proceeds of the bonds to finance an addition to its water and sewer system. Debt service on the bonds will be paid solely from the water and sewer payments received by City X. The bonds are revenue bonds.

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**Example 3** City Y issues bonds and uses the proceeds of the bonds to construct a toll road. Debt service on the bonds will be paid solely from the tolls collected from the users of the toll road. The bonds are revenue bonds.

The bondholders of revenue bonds may have a first lien on the revenues of the facility financed with the proceeds of the bonds or a mortgage on the facility, or both.

If the issuer defaults on payment of debt service on the bonds, the bondholders may exercise any remedy against the issuer and the facility, including foreclosing on the facility.

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## Governmental Bonds, Continued

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### **Double-Barreled Bonds**

Double-barreled bonds, are secured not only by, the revenues from a certain source, but also by the full faith and credit of the issuer.

Generally, double-barreled bonds are issued to avoid certain provisions of state law regarding limitations on debt that can be issued by the issuer.

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### **Example 4**

City X issues bonds to finance the construction of a recreation center. City X pledges the revenues from the recreation center to pay debt service on the bonds. Because of lack of historical data on the recreation center's revenues, City X also pledges its full faith and credit to pay debt service on the bonds. The first source of debt service will be revenues of the recreation center, and only if these are insufficient will the city use its taxes. City X's pledge of its full faith and credit helps it to sell the bonds at a lower interest rate.

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### **Special Assessment Bonds**

Debt service on special assessment bonds is payable from revenues derived by the issuer from special assessments levied on the owners of the property subject to public improvements financed with the proceeds of the bonds. These bonds are not secured by the full faith and credit of the issuer.

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### **Example 5**

County A issues bonds to finance water and sewer lines, grading, curbing, and road improvements in a new subdivision to be built within its jurisdiction. The debt service on the bonds is payable solely from assessments on owners of property in the subdivision. The assessments are based on the frontage of each owner's property. These are special assessment bonds.

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## Governmental Bonds, Continued

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<b>Tax Increment Financing (TIF) Bonds</b>	Debt service on TIF Bonds is payable from incremental increases of tax revenues derived from a certain area which has been improved and developed with the proceeds of the bonds. TIF bonds may be used to develop blighted areas in a community or for economic development to increase the tax base.
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<b>Example 6</b>	<p>County A has a 3-acre area that has shuttered store fronts and abandoned homes. The area is adjacent to office buildings and shops that are heavily populated during the business hours. As part of its redevelopment plan, County A wants to issue bonds to finance the redevelopment of the blighted area so as to encourage new businesses to relocate there. As a result of the relocation of new businesses, County A anticipates the taxes generated from the redeveloped area to incrementally increase each year. The debt service on the bonds will be paid from this incremental increase in taxes.</p>
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Although the bonds are payable from taxes levied on property owners in the tax increment district, because the general taxing power of the issuer does not secure the bonds, the bonds are not general obligation bonds.

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<b>Lease Financings</b>	An entity may enter into a lease with a municipality. Under revenue rulings 55-540 and 72-399, a lease agreement can be treated as a tax-exempt financing if both:
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- the periodic payments made by the municipal lessee have a defined interest component which the lessor can identify as exempt income; AND
- the agreement is substantively a conditional sales contract.

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## Governmental Bonds, Continued

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### **Lease Financings (continued)**

Rev. Rul 55-540 provides 6 characteristics one or more of which, under the facts and circumstances, can indicate a conditional sales contract:

- a portion of the periodic payments are designated as equity acquired by the municipal lessee.
- the municipal lessee acquires title to the property upon the making of a required number of payments.
- the required periodic payments for a the lease period are inordinately large in relation to the purchase option payment required for transfer of title.
- the agreed upon lease payments materially exceed the fair rental value of the leased property.
- title to the property may be acquired under a purchase option at a stated price which is nominal in relation to either the total payments required to be made or the projected value of the property at the time the option may be exercised.
- the lease payment paid by the municipal lessee has a defined interest component which the lessor may treat as exempt income.

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### **Example 7**

Fire protection district enters into a lease purchase contract for a fire engine and equipment. Under the lease agreement, ownership title of the vehicle and equipment transfers to district upon final payment. The lease agreement designates 8 percent of the monthly lease payment as representing interest on the financing.

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## Governmental Bonds, Continued

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### Certificates of Participation (COPs)

A COP is a certificate issued to an investor that entitles the investor of the COP to a portion of the revenues received by the lessor under a lease. For the interest on COPs to be exempt from federal taxation, the lessee **MUST** be a municipality.

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### Example 8

City B needs a new jail. It does not want to issue GO Bonds because it is limited under state law from issuing debt without a voter referendum. Because the city does not want to hold a referendum, it establishes Corporation X. The sole purpose of Corporation X is to construct the jail and lease it to the city for 30 years. City B, Corporation X, and the trustee enter into a 30-year lease for the jail. The lease is an investment. Corporation X invites investors to participate in this investment and issues certificates of participation (COPs) to the investors. The money received from the purchases of the COPs is used by Corporation X to construct the jail. The COPs have a 30-year maturity and the debt service on the COPs is equal to the lease payments made by City B to Corporation X. When the COPs are paid off, the lease terminates, and the title to the jail is transferred to City B.

Corporation X is referred to as an “on-behalf-of issuer.” This concept is more fully discussed in Module D.

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### Short-Term Municipal Debt

A state or local government may issue debt that matures within a short time after issuance. Such debt generally has a maturity of:

- less than 270 days, in the case of commercial paper,
  - less than one year, in the case of Tax Anticipation Notes, OR
  - one to three years, in the case of Bond Anticipation Notes.
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## Governmental Bonds, Continued

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### **Bond Anticipation Notes (BANs)**

Bond Anticipation Notes are short-term notes issued to finance a project when the issuer expects to pay off the notes with the proceeds of long-term bonds to be issued in the future.

Because the issuer usually invests bond proceeds for a short time, the interest rate earned by the issuer on the investments is lower than the interest rate paid by the issuer on long-term bonds. To avoid this investment loss, an issuer may issue short-term Bond Anticipation Notes ("BANs"), which are later replaced by long-term bonds. Because the issuance of BANs reduces investment loss, it also lowers borrowing costs.

BANs may be secured by the full faith and credit of the issuer, or the revenues from a specific source.

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### **Example 9**

City X wants to finance the construction of a recreation center. The interest rate on long-term bonds is 7%. City X knows that during the construction period, it can invest the proceeds of the bonds at an average interest rate of 3%. If City X issues long-term bonds, it will be paying out interest at 7% to the bondholders while receiving only 3% on its investments. City X can instead issue BANs with a one-year maturity at an interest rate of 3.5%. Although its investment rate is still less than the interest rate on its debt, the difference between the rates has been reduced. The issuer has therefore reduced its net borrowing costs.

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### **Tax and Revenue Anticipation Notes (TRANs)**

TRANs are short-term notes issued when the issuer expects to pay them off when it receives the next payment of taxes or other revenue. If an issuer receives most of its tax revenues at certain times during the fiscal year, the issuer may suffer cash flow problems in meeting its budgetary needs. To overcome the shortfall, the issuer may issue TRANs.

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### **Example 10**

City X's fiscal year ends on December 31, and property taxes are due on September 1 and March 1. City X anticipates a cash flow shortfall in June. It issues TRANs in May for purposes of meeting its cash flow shortfall. These TRANs will be paid from property taxes received by City X on September 1 and March 1.

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# Private Activity Bonds

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**Definition** Nongovernmental bonds are also called private activity bonds. For the interest on private activity bonds to be exempt from federal income tax, the bonds must meet the requirements under IRC §§ 141 through 150.

The proceeds of private activity bonds are loaned by the issuer to a private entity and used by the borrower for nongovernmental purposes.

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**Example 11** County A loans the proceeds of the bonds to Corporation X, a tax-exempt organization, to be used by the Corporation to acquire a nursing home. Corporation X will repay the loan to the county in amounts sufficient to make timely debt service payments on the bonds. Because the bonds are revenue bonds, if Corporation X fails to make the loan repayments, County A is not required to pay debt service on the bonds out of its own funds.

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**Example 12** Industrial Development Authority of City A (“the Authority”) loans the proceeds of the bonds to Corporation Y, a for-profit organization, to be used by Corporation Y to construct a facility that manufactures machine parts. Corporation Y will repay the loan to the Authority in amounts sufficient to make timely debt service payments on the bonds. Because the bonds are revenue bonds, if Corporation Y fails to make the loan repayments, the Authority is not required to pay debt service on the bonds out of its own funds.

Module D discusses the differences between governmental and private activity bonds.

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## Pooled Financings

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**Definition** In a pooled financing, the proceeds of the bonds are loaned by the issuer to more than one borrower. The borrowers of the proceeds may be for-profit corporations, tax-exempt organizations, or other state or local governments. The borrowers must NOT be related parties.

Pooled financings may involve proceeds of governmental bonds or private activity bonds.

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**Example 13** State X issues bonds for the purpose of loaning the proceeds to various school districts in its jurisdiction. Three school districts borrow the proceeds to build new schools. This is a pooled financing.

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**Example 14** State Y issues bonds for the purpose of loaning the proceeds to tax-exempt higher educational organizations in its jurisdiction. One university borrows part of the proceeds and purchases computer equipment and a new building for its administrative offices. A community college borrows the remaining proceeds to construct classrooms. This is a pooled financing.

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## Section 3

### Parties to the Transaction

#### Overview

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##### Introduction

A municipal bond financing involves many different parties. Each party:

- plays a defined role in the transaction, AND
- has defined duties and obligations to the bondholders and other parties to the financing.

This section breaks up these parties into three categories. The first category includes those parties who are central to the transaction, and are, therefore involved in nearly every municipal bond financing.

The second category discusses credit enhancers. Credit enhancers may or may not be involved in the transaction.

The third category discusses rating agencies. Rating agencies may or may not be involved in the transaction.

This section defines each of these parties and describes each of their roles in the transaction.

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## Parties Central to the Transaction

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<b>Issuer</b>	<p>The issuer may be:</p> <ul style="list-style-type: none"><li>• a state,</li><li>• a local government, or</li><li>• an entity that can issue bonds on behalf of a state or local government.</li></ul> <p>Module D discusses valid issuers under IRC § 103.</p>
<b>Example 15</b>	<p>City X issues bonds and uses the proceeds of the bonds to finance an addition to its water and sewer system. City X is the issuer.</p>
<b>Example 16</b>	<p>Industrial Development Authority of City A (“the Authority”) issues bonds and loans the proceeds to Corporation Y, a non-profit organization, to be used by Corporation Y to construct a retirement community. The Authority is the issuer.</p>
<b>Conduit Borrower</b>	<p>The conduit borrower is:</p> <ul style="list-style-type: none"><li>• the borrower of the proceeds that is other than the issuer.</li><li>• required to make payments to the issuer in such amounts, and at such times to permit the issuer to make timely payments of debt service on the bonds.</li></ul>
<b>Example 17</b>	<p>County A issues bonds and loans the proceeds to Corporation X, a for-profit organization, to be used by Corporation X to construct a manufacturing facility. Corporation X will repay the loan to County A in amounts sufficient to make timely debt service payments on the bonds. Corporation X is the conduit borrower.</p>
<b>Trustee</b>	<p>A trustee:</p> <ul style="list-style-type: none"><li>• is an entity who represents the bondholders and acts on their behalf when necessary.</li><li>• receives the debt service payments from the issuer or conduit borrower, and pays these to the bondholders.</li><li>• holds the unexpended bond proceeds and other funds, such as the debt service fund, reserve fund, etc.</li></ul>

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## Parties Central to the Transaction, Continued

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<b>Example 18</b>	County X wants to issue bonds in the principal amount of \$10,000,000. The bonds will be sold in denominations of \$5,000. There will be many bondholders. All of these bondholders cannot negotiate with County X to make sure their interests are protected. Therefore, County X retains Bank A to act as the representative of the bondholders. Bank A is the trustee.
<hr/>	
<b>Underwriter</b>	An underwriter is an entity that purchases the bonds from the issuer on the date of issuance and resells them to the bondholders.
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<b>Example 19</b>	County X wants to issue bonds in the principal amount of \$10,000,000. The bonds will be sold in denominations of \$5,000. County X wants to sell the bonds to the general public. It retains Firm Y to solicit bids for the bonds. After soliciting bids, Firm Y will identify bondholders. On the date of issuance of the bonds, Firm Y will purchase the entire principal amount of the bonds from County X on behalf of the bondholders. On the same date, Firm Y will resell the bonds to the bondholders at the principal amount. Firm Y is the underwriter.
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<b>Financial Advisor</b>	The financial advisor is an entity that advises the issuer regarding financial matters related to the issuance of its bonds. A conduit borrower may also have its own financial advisor.
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<b>Example 20</b>	State Y issues many series of bonds each year. It has a contract with Firm B for a period of three years to advise it on each of its bond financings. Firm B is the financial advisor to State Y.
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<b>Example 21</b>	Assume in the above example, that State Y loans the proceeds to Hospital D. Hospital D is a large hospital and has borrowed bond proceeds on numerous occasions. To advise it on these borrowings, Hospital D retains Firm Q. Firm Q is the financial advisor to Hospital D.

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## Parties Central to the Transaction, Continued

### Various Counsels in the Financing

Each party to the transaction generally retains legal counsel to protect its interest, as shown in the table below:

ROLE OF COUNSEL	RESPONSIBILITY
Bond counsel	Renders an opinion on the issuance date of the bonds that the: <ul style="list-style-type: none"><li>• bonds are validly issued by the issuer, AND</li><li>• interest on the bonds is not included in the gross income of the bondholders for federal income tax purposes.</li></ul>
Underwriter's counsel	<ul style="list-style-type: none"><li>• Advises the underwriter on federal and state securities law issues, AND</li><li>• renders an opinion on the issuance date that the offering documents:<ul style="list-style-type: none"><li>• are true and correct,</li><li>• do not include a statement that is misleading, AND</li><li>• do not fail to include any statement, the omission of which would be misleading.</li></ul></li></ul>
Borrower's counsel	Represents the conduit borrower in the financing
Issuer's counsel	Represents the issuer in the financing.

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## Parties Central to the Transaction, Continued

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### Depository

A depository is an organization that:

- holds the actual municipal bonds, AND
- maintains records on its books.

These are called “book-entry” bonds.

Instead of printing bonds for each bondholder, the issuer issues one certificated bond for each maturity. No other certificates exist with regard to the bond issue. The bondholders do not receive any certificated bonds. Each bondholder receives a statement from his broker-dealer stating ownership of the bonds.

Several depositories handle municipal bonds, but Depository Trust Company (DTC), located in New York City, is the largest one.

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# Credit Enhancers

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## Introduction

A credit enhancer is a party unrelated to the issuer or conduit borrower, who lends its credit to the payment of debt service on the bonds. As a result of the involvement of the credit enhancer, the bonds bear a lower interest rate than they would have without the credit enhancer.

Credit enhancement may be in the form of:

- mortgage insurance,
- bond insurance,
- guarantee, OR
- letter of credit.

Each of these is discussed below.

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## Mortgage Insurance

Mortgage insurance is an agreement by a third party to insure the mortgage payments to be made by the conduit borrower to the trustee.

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## Example 22

Industrial Development Authority of City B issues bonds and loans the proceeds to Corporation X. Corporation X will use the proceeds to construct a low-income multifamily project. As security for the payments to be made by Corporation X to the issuer, the issuer will have a mortgage on the project. Because Corporation X has no financial history, the bonds are a risky investment and will be difficult to sell. The Federal Housing Administration (FHA) insures the mortgage payments to be made by Corporation X to the issuer.

If Corporation X fails to make the required payments to the trustee, the trustee notifies FHA that the mortgage is in default. FHA makes payments on the mortgage on behalf of Corporation X. FHA can then foreclose on the project.

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## Credit Enhancers, Continued

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### **Bond Insurance**    Bond insurance:

- is provided by a third-party insurance company, who in return for a premium, irrevocably and unconditionally agrees to insure the timely payment of the principal of and interest on the bonds.
- remains in place for the entire term of the bonds.

The issuer pays the bond insurer a premium on the date of issuance of the bonds.

Even if the bonds are insured, the obligor (conduit borrower or issuer) remains the party primarily responsible to make payments of debt service on the bonds.

On the issuance date of the bonds, it is expected that, barring unforeseen circumstances, the obligor will be able to meet its responsibility.

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### **Example 23**

The Economic Development Authority of City A issues bonds and loans the proceeds to Corporation X. The bonds are credit enhanced by a bond insurance policy. The debt service on the bonds is due on each January 1 and June 1. Corporation X is required to make loan payments to the trustee on each December 25 and May 25. The trustee uses the loan payments made by Corporation X to make debt service payments to the bondholders.

If on May 25 of one year, Corporation X fails to make the required payment to the trustee, the trustee will inform the bond insurer that Corporation X is late in its payment. If by May 31, the trustee has not received the complete payment from Corporation X, it will call the bond insurer, who will wire the amount necessary to the trustee. The trustee will use that amount to pay debt service on the bonds on June 1.

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## Credit Enhancers, Continued

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**Guarantee** A guarantee is an agreement between the trustee and a third party under which the third party guarantees to make payments if the issuer or the conduit borrower (as the case may be) fails to meet its obligations.

The party guaranteeing to pay on behalf of the issuer or conduit borrower is called the “guarantor.” This may be a party related or unrelated to the issuer or conduit borrower.

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**Example 24** County X issues bonds and loans the proceeds to Corporation Y, a nonprofit organization, to construct a cancer research center. Because Corporation Y is a new entity, with no previous history, the bonds are not marketable. Corporation Y’s parent, Corporation Z, a nonprofit hospital organization that has been in business for over fifty years, agrees to guarantee the payment of debt service on the bonds. Corporation Z’s guarantee is a credit enhancement.

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**Letter of Credit** A letter of credit is a commitment by a third-party bank (LOC Bank) to a bond issuer or conduit borrower, to pay the debt service on the bonds when due. The payment of debt service on the bonds is still the primary obligation of the issuer or the conduit borrower.

The term of the LOC is usually short, such as three to five years. Unless renewed by the LOC Bank and the account party, the LOC automatically expires on its expiration date.

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## Credit Enhancers, Continued

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**Letter of Credit**    The parties of the LOC and their roles are described below:  
(continued)

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<b>PARTY</b>	<b>ROLE</b>
Account party	<ul style="list-style-type: none"><li>• Customer of the LOC Bank (may be issuer or conduit borrower).</li><li>• Pays an upfront fee to the LOC Bank (based on principal amount of bonds).</li><li>• Pays an annual ongoing fee during the term of the LOC.</li></ul>
Addressee	<ul style="list-style-type: none"><li>• Trustee (the LOC is addressed to the trustee, and payments are made to the trustee by the LOC Bank).</li></ul>

The table below illustrates how the LOC works:

<b>Step</b>	<b>Action</b>
1	On each debt service payment date, the trustee sends a sight draft to the LOC Bank requesting a draw on the LOC in an amount sufficient to make the payment due on the bonds on that date.
2	The LOC Bank wires the amount on the sight draft to the trustee. The principal amount of the LOC is reduced by the amount of the draw.
3	Trustee uses the amount received from the LOC Bank to pay debt service on the bonds.
4	The account party reimburses the LOC Bank for the amount of the draw reinstating the LOC to its original amount. The reimbursement to the LOC Bank is pursuant to an agreement (the “reimbursement agreement”) between the LOC Bank and the account party.

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## Credit Enhancers, Continued

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### Example 25

City A issues bonds and loans the proceeds to Corporation B to be used to construct a resource recovery facility. Corporation B is certain that about two years after construction, the facility will produce sufficient revenues to pay debt service on the bonds. But, at the time of issuance, there is no financial history regarding the facility. Corporation B and City A believe that the bonds will sell at a lower interest rate if they are credit enhanced. Corporation B believes that it needs credit enhancement only for a short time, until the facility's revenues are stabilized.

Corporation B enters into an agreement with Bank C, in which Bank C will provide an LOC for a term of five years. Corporation B anticipates construction to be complete in two years. This would give the facility three years to stabilize its revenues.

Corporation B negotiates with Bank C who agrees to issue an LOC for an upfront fee of 0.5% of the principal amount of the bonds and an annual ongoing fee of 0.125% of the outstanding principal amount of the bonds. Bank C is rated "Aa." Based upon this rating, Corporation B will have a substantial reduction in the debt service on the bonds. Bank C issues an LOC for a term of five years.

Bank C and Corporation B enter into a reimbursement agreement under which Corporation B agrees to reimburse Bank C after each draw on the LOC.

On each January 1 and June 1, the debt service payment dates, the trustee sends a sight draft to Bank C in an amount equal to the debt service payment on the bonds on that date. Bank C wires the money to the trustee and the trustee uses the money to pay the bondholders.

Under the reimbursement agreement, Corporation B is required to reimburse Bank C in the amount of the draw on the LOC.

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## Credit Enhancers, Continued

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### Example 26

Assume that in Example 1 the LOC expires on June 5, 2000. The bondholders purchased the bonds based upon the credit enhancement provided by Bank C. They wanted bonds that are rated “Aa.” When the LOC expires, they have the right to tender the bonds unless Corporation B provides a new LOC with the same rating. If Corporation B decides that the facility’s revenues are sufficient, it may remarket the bonds on June 1, 2000 without any credit enhancement.

Early in the Year 2000, long-term interest rates are down. Corporation B believes that the facility can manage to pay debt service on the bonds at the prevailing fixed interest rate. Corporation B asks the trustee to send notices to bondholders that the LOC will expire on June 5, 2000 and will not be renewed.

On June 1 all bondholders tender their bonds to the trustee. The trustee makes a final draw on the LOC and pays the bondholders. The LOC amount is down to zero.

Corporation B remarkets the bonds as fixed rate bonds without credit enhancement. The purchase price paid by the new bondholders is used by Corporation B to reimburse Bank C.

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# Rating Agencies

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<b>Definition</b>	<p>A rating agency is a firm that provides an opinion of the relative investment merit of the bonds. The three most common rating agencies are Moody's, Fitch, and Standard &amp; Poor's.</p> <p>The rating is based upon the issuer's or the conduit borrower's credit worthiness. If the bonds have credit enhancement, the rating is based upon the credit worthiness of the credit enhancer.</p> <p>The rating on the bonds may be down-graded or upgraded after issuance depending on any changes in the long-term debt rating (or credit worthiness) of the party upon which the rating on the bonds is based.</p>
<b>Example 27</b>	<p>County X issues bonds for the purpose of financing its office building. The bonds will be GO bonds. County X's long-term debt is rated "AAA" by a rating agency. The bonds will be rated "AAA."</p>
<b>Example 28</b>	<p>Industrial Development Authority of City B issues bonds and loans the proceeds of the bonds to Corporation X for the purpose of constructing a low-income multifamily housing project. Corporation X has no financial history. Corporation X enters into an agreement with a bond insurer to insure the debt service payments on the bonds. The bond insurer's long-term debt rating at the time of issuance of the bonds is "AAA." The bonds will be rated "AAA."</p>

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## Section 4

### Maturities and Interest Rates

#### Overview

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##### Introduction

The maturity date of a bond is the date on which the entire outstanding principal of the bond must be paid to the bondholder. An issue may be made up of bonds having serial maturities (serial bonds) or bonds having term maturities (term bonds), or both.

The interest rate on bonds can be fixed or variable.

A fixed interest rate does not change and is known on the date of issuance of the bonds.

The interest rate on variable rate bonds fluctuates from time to time and cannot be determined on the date of issuance.

This section discusses all of these concepts.

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##### Contents

This section contains the following topics:

Topic	See Page
Overview	A-28
Bond Maturities	A-29
Rate Setting Method for Variable Rate Bonds	A-32
Remarketing	A-34
Liquidity Facility	A-36

---

## Bond Maturities

<b>Serial Bonds</b>	Serial bonds are a series of bonds with individual maturities. Usually in an issue of bonds, the serial bonds mature annually.
<b>Term Bonds</b>	A term bond is a bond that has a single final maturity date. All or a large part of an issue of bonds may be sold as one or more term bonds. Term bonds usually have mandatory payments called sinking fund payments. This permits the issuer to make level debt service payments.
<b>Example 29</b>	<p>County X issues bonds in 1996. On the date of issuance of the bonds, County X knows that the final maturity of the bonds is in year 2023. County X also knows that the bonds will bear the interest rates and will have the maturities shown below in <b>Table A-1</b>.</p> <p>The bonds maturing from 1998-2007 are called serial bonds. Each serial bond has its own maturity and is due and payable on that date.</p> <p>The bonds maturing in 2012, 2017, and 2023 are called term bonds. Because the issuer does not want to pay the entire \$6,000,000 in 2012, nor the entire \$12,750,000 and \$15,225,000 in the years 2017 and 2023, respectively, it will establish a schedule that requires it to pay a portion of the term bond in each year. This is called a sinking fund schedule. The issuer deposits sinking fund payments into a bona fide debt service fund held by the trustee, who then uses these funds to pay the bondholders. As a result of the payments, a bondholder may get all or a portion of its bond paid off. This is as shown below in <b>Table A-2</b>.</p>

*Continued on next page*

## Bond Maturities, Continued

**Example 29**  
(continued)

**Table A-1**

Year of Maturity	Principal Amount	Interest Rate
1998	\$ 500,000	4.45%
1999	550,000	4.70
2000	600,000	4.85
2001	625,000	4.95
2002	675,000	5.05
2003	700,000	5.20
2004	800,000	5.30
2005	850,000	5.40
2006	905,000	5.50
2007	1,000,000	5.60
2012	6,000,000	6.25
2017	12,750,000	6.50
2023	15,225,000	6.75

*Continued on next page*

## Bond Maturities, Continued

Example 29  
(continued)

**Table A-2**

<b>For Bonds Maturing in 2012</b>	
<b>Sinking Fund Payment</b>	<b>Principal Amount</b>
2008	\$1,200,000
2009	1,200,000
2010	1,500,000
2011	1,500,000
2012	600,000

  

<b>For Bonds Maturing in 2017</b>	
<b>Sinking Fund Payment</b>	<b>Principal Amount</b>
2012	\$1,500,000
2013	1,575,000
2014	1,750,000
2015	2,500,000
2016	2,675,000
2017	2,750,000

  

<b>For Bonds Maturing in 2023</b>	
<b>Sinking Fund Payment</b>	<b>Principal Amount</b>
2018	\$1,575,000
2019	1,750,000
2020	2,000,000
2021	2,500,000
2022	3,325,000
2023	4,075,000

## Rate Setting Method for Variable Rate Bonds

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### **Determination of Rate**

The interest rate on variable rate bonds:

- is established at the times and in a manner agreed upon by the issuer and the bondholders on the issuance date of the bonds.
- may be set daily, weekly, monthly, quarterly, etc.
- may be based upon a market index, such as JJ Kenny Index or on Treasury bills.
- is determined by offering the bonds in the market at par. The rate at which the bonds are sold at par on each rate setting date is the interest rate on the bonds.
- is determined in accordance with the bond documents executed at the time of issuance of the bonds.

The issuer retains an agent, called the “remarketing agent,” to set the interest rate on the bonds.

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### **Example 30**

The issuer issues variable rate bonds, the interest rate on which varies on a weekly basis. The interest rate on the bonds is determined on each Tuesday and is applicable on the following Wednesday. Tuesday is the interest rate determination day for the bonds.

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### **Interest Rate Period**

The interest rate period is the period between two rate-setting dates. The interest rate may change as often as daily or weekly, or as infrequently as yearly.

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### **Example 31**

The issuer issues variable rate bonds. The interest rate changes weekly, on each Wednesday. The interest rate period is from each Wednesday to the next Tuesday.

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*Continued on next page*



## Rate Setting Method for Variable Rate Bonds, Continued

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<b>Tender Right</b>	Because the interest rate varies, the bondholders have the right to tender (sell to the issuer) the bonds every time a new interest rate is set for the bonds.
<hr/>	
<b>Example 32</b>	The interest rate on the bonds is set on each Tuesday and will be applicable from Wednesday to the following Tuesday. On April 3, a Tuesday, the interest rate is determined by, the remarketing agent for the issuer. The interest rate on the bonds for the next interest rate period will be 3.25%. The interest rate for the previous interest rate period was 3.35%. On April 3, Bondholder 1, who holds \$100,000 principal amount of bonds, learns of the new interest rate. Bondholder 1 has the right to tender its bonds to the trustee on Wednesday, April 4.
<hr/>	
<b>Purchases of Tendered Bond</b>	When a bondholder has a right to tender a bond, the issuer is required to purchase the bonds from that bondholder. Usually the purchase price is the principal amount of the bonds plus interest accrued on the bonds from the previous interest payment date.
<hr/>	

# Remarketing

<b>Definition</b>	Remarketing is the resale of a bond in the secondary market, after the bond has been tendered by its holder.
<b>Remarketing Agent</b>	A variable rate bond may be tendered, by a bondholder, on any date that the interest rate is reset. In order to keep the bond outstanding, the issuer retains an agent to resell the tendered bond to a new bondholder.
<b>Remarketing Agreement</b>	<p>The issuer and the remarketing agent enter into a remarketing agreement, which requires the remarketing agent to perform the following duties:</p> <ul style="list-style-type: none"><li>• set the variable interest rate on the bonds on each interest rate determination date.</li><li>• inform the current bondholders of the rate that will be applicable during the next interest rate period.</li><li>• use its best efforts to resell any tendered bond to another purchaser.</li><li>• use the purchase price paid by the new bondholder to pay off the current bondholder.</li><li>• use the liquidity facility to pay off the current bondholder, if the agent cannot resell the bonds. <b>(See Liquidity Facility, next.)</b></li></ul>
<b>Example 33</b>	<p>Bondholder A owns a variable interest rate bond the rate on which is 3.25%. On Tuesday, April 3, the remarketing agent informs all of the bondholders that the interest rate on the bonds for the next interest rate period will be 3.0%. Bondholder A does not like that interest rate, and informs the remarketing agent that the bonds will be tendered to the trustee on Wednesday, April 4. The remarketing agent begins looking for a new purchaser for A's bond. B agrees to purchase A's bond at par. On April 4, A's tendered bond will be immediately purchased by B. The remarketing agent will use the purchase price paid by B to pay A the tender price for the bond.</p>

*Continued on next page*

## Remarking, Continued

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<b>What if a Buyer Can Not be Found?</b>	If a buyer for a tendered bond cannot be found, how will the remarketing agent pay off the bondholder? Because an issuer generally does not have cash available to pay the tender price of variable rate bonds, the issuer will obtain a liquidity facility. Liquidity facilities are discussed next.
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# Liquidity Facility

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<b>Definition</b>	<p>A liquidity facility is an agreement with a third party, usually a bank, to provide ready cash to purchase the bonds when required under the bond indenture.</p> <p>A liquidity facility may be as a:</p> <ul style="list-style-type: none"><li>• letter of credit, or</li><li>• stand-by bond purchase agreement.</li></ul>
<b>Letter of Credit (LOC)</b>	<p>When a bondholder tenders the bond, the trustee draws on the LOC to pay the bondholder. If the LOC is only a liquidity facility, and NOT a credit enhancement, the LOC only pays the purchase price of the bonds tendered by the bondholders. This LOC will NOT pay the regular debt service payments on the bonds.</p>
<b>Reimbursement of LOC Bank</b>	<p>If the remarketing agent has been successful in remarketing the bond to a new bondholder, the purchase price paid by the new bondholder is used to reimburse the LOC Bank.</p>
<b>Bank Bonds</b>	<p>If the remarketing agent is unsuccessful in remarketing the bond, the LOC Bank becomes the new bondholder. The bond is referred to as a “Bank bond,” while the LOC Bank is the bondholder.</p>
<b>Stand-By Bond Purchase Agreement</b>	<p>This is an agreement between a bank, the trustee, and the issuer under which the bank agrees to purchase the bonds tendered by a bondholder that have not been remarketed by the remarketing agent.</p>

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*Continued on next page*

## Liquidity Facility, Continued

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**Example 34**

State X issues variable interest rate bonds. On the date of issue, State X and the trustee enter into a stand-by purchase agreement with Bank A. On April 4, the remarketing agent is unable to remarket the bond tendered by Bondholder 1. The trustee will ask Bank A to purchase Bondholder 1's bond. The purchase price paid by Bank A is used to pay Bondholder 1 the tender price for its bond. Bank A becomes the new bondholder until the bond can be remarketed by the remarketing agent. During this time period, the bond is a "Bank bond."

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# Section 5

## Bond Transcripts, Securities Regulations, and Issuance Costs

### Overview

---

#### Introduction

This section provides an introduction to:

- the basic bond documents that are signed and delivered on the date of issuance of the bonds,
- securities law, AND
- costs of issuing the bonds

An in-depth discussion of these topics is beyond the scope of this course, however, when appropriate, the text refers to other sources that will provide additional information.

---

#### Contents

This section contains the following topics:

Topic	See Page
Overview	A -38
Introduction to the Bond Transcript	A-39
Offering Documents	A-44
Basic Legal Documents	A-47
Funds Created Under the Indenture	A-48
Securities Regulations	A-50
Costs of Issuing the Bonds	A-51

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# Introduction to the Bond Transcript

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## **What is a Bond Transcript?**

The bond transcript is also called the “bound volume.” This is simply a compilation of the bond documents executed and delivered on the date of issuance of the bonds. Not all of the documents in a transcript are relevant to the federal tax analysis.

The bond transcript will include most, but not all, of the bond documents necessary to examine a bond issue. Some of the documents necessary for the agent to complete an audit are created AFTER the bonds are issued. Therefore, these documents are NOT included in the bond transcript.

The bond transcript may be thought of as a blueprint for the bond issue. It does NOT disclose how the plans were carried out, nor how the bond proceeds were actually invested and used. The agent must determine whether the events contemplated by the bond documents actually occurred.

---

## **Additional Information**

For a detailed description of the bond documents, see Understanding Bond Documents, Continuing Professional Education Tax Exempt Bonds Technical Instruction Program for FY 2002, Training 4233-001 (8-2001), reprinted from Continuing Professional Education Exempt Organizations Technical Instruction Program for FY 1996, Training 4277-048 (7-1995).

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## **Information Provided in the Bond Transcript**

Most bond examinations should begin with a review of the bond transcript. The bond transcript can provide useful information to help focus and plan the rest of the examination including:

- purpose of the bond issue,
  - type of bond issue, such as general obligation, revenue, etc,
  - parties involved in the transaction, such as conduit borrower, trustee, bond counsel, underwriter,
  - facilities to be financed,
  - use of bond proceeds, such as acquisition, construction, reimbursement, refunding,
  - flow of bond proceeds from trustee to issuer or conduit borrower,
  - source of payment of debt service to bondholders
  - funds involved, such as construction, escrow, debt service, reserve, etc,
  - related bond issues (if refunding),
  - TEFRA requirements for qualified private activity bonds, AND
  - any elections made by the issuer.
- 

*Continued on next page*

## Introduction to the Bond Transcript, Continued

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### **Bond Transcript is a Public Record of the Issuer**

The bond transcript is prepared by the bond counsel after the bonds have been issued. Bond counsel provides a copy of the bond transcript to each major party to the financing and their attorneys.

The bond transcript is part of the public record of the bond issuer.

The transcript contains documents that were considered necessary to the parties to the transaction. The issuance and sale of the bonds would not have occurred without the execution and/or delivery of the documents.

There are no requirements in the municipal financing industry regarding the sequence of documents in a bond transcript. The sequence depends entirely upon bond counsel.

---

### **Categories of Documents in Transcript**

Most bond transcripts contain the following categories of documents:

- offering documents,
- basic legal documents,
- resolutions and certificates of parties,
- legal opinions, and
- miscellaneous.

See **Figure A-1** for a detailed listing of documents in each category.

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*Continued on next page*



## Introduction to the Bond Transcript, Continued

Figure A-1

### DOCUMENTS CONTAINED IN MOST BOND TRANSCRIPTS

<b>Offering Documents</b>	<ul style="list-style-type: none"> <li>• Preliminary Official Statement</li> <li>• Official Statement</li> <li>• Bond Purchase Agreement</li> <li>• Blue Sky Survey</li> </ul>
<b>Basic Legal Documents</b>	<ul style="list-style-type: none"> <li>• Indenture/Resolution</li> <li>• Loan/lease agreement</li> <li>• Mortgage/deed of trust</li> <li>• Request to authenticate and deliver bonds</li> <li>• Credit enhancement documents</li> <li>• No arbitrage certificate/tax regulatory agreement</li> <li>• Form 8038/8038-G</li> <li>• Land use restriction agreement</li> <li>• TEFRA approval/volume cap certificate</li> </ul>
<b>Resolutions and Certificates of Parties</b>	<ul style="list-style-type: none"> <li>• Copy of the relevant state law</li> <li>• Organizational documents of the issuer</li> <li>• Resolution(s) of the issuer authorizing the financing</li> <li>• Certificates of the issuer</li> <li>• Organizational documents of the conduit borrower</li> <li>• Certificates of the conduit borrower</li> <li>• Certificate of the credit enhancer</li> <li>• Certificate of the trustee</li> </ul>
<b>Legal Opinions</b>	<ul style="list-style-type: none"> <li>• Opinions of bond counsel</li> <li>• Opinion of underwriter's counsel,</li> <li>• Opinion of counsel to the conduit borrower</li> <li>• Opinion of credit enhancer's counsel</li> </ul>
<b>Miscellaneous</b>	<ul style="list-style-type: none"> <li>• Rating letter(s)</li> <li>• Receipts for the bonds and proceeds</li> <li>• Feasibility study/engineer's report</li> <li>• Title insurance</li> <li>• Financing statement</li> <li>• Appraisal</li> </ul>

*Continued on next page*

## Introduction to the Bond Transcript, Continued

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### Official Statement or “O/S”

The official statement (also referred to as the “offering memorandum,” or the “private placement memorandum”) is the document used by the underwriter to sell the bonds to potential buyers.

It is the counterpart of the **prospectus** in the corporate finance industry.

The quickest way to learn about a bond financing is to read the official statement.

The official statement includes the following information:

- terms of the bonds,
  - sources of payment for the bonds (debt service),
  - purpose of the bond issue,
  - sources and uses of bond proceeds and other money, if any, AND
  - summary of important terms of the legal documents for the bond issue.
- 

### Cover Page of Official Statement

The cover page of the official statement provides a quick summary of the bond issue and usually has:

- name of the bond issuer,
- name of the conduit borrower (if any) and name of project financed with the bonds,
- principal amount of the bonds,
- list of major participants including bond counsel, trustee, and underwriter,
- issue date of the bonds,
- interest and principal amount of each maturity of the bonds,
- security for the bonds, AND
- purpose of the bonds.

The name of the bond issue gives very basic information regarding the financing. The name indicates whether the bonds are general obligation or revenue bonds.

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*Continued on next page*

## Introduction to the Bond Transcript, Continued

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**Cover Page of  
Official  
Statement**  
(continued)

The cover page also contains a short statement regarding the exclusion of interest on the bonds from the gross income of bondholders.

The date of issue, posted at the bottom of the cover page, is the date when the bonds are delivered to the underwriter.

After reviewing the official statement, the agent will have an overview of the financing structure.

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# Offering Documents

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## **Tax Regulatory Agreement, “TRA”**

The transcript may have one or many tax documents, such as the:

- tax regulatory agreement, AND
- arbitrage certificate.

These two documents may be combined into one document.

The tax regulatory agreement is generally between the issuer and trustee. In a conduit financing, the conduit borrower will also be a party to the TRA.

The TRA states the representations and warranties of the issuer or conduit borrower regarding the expenditure of bond proceeds, and the use of the project in accordance with the purposes for which it was financed.

If the transaction involves qualified 501(c)(3) bonds, the conduit borrower will make representations regarding its exempt status and promises that it will not perform any acts or enter into any agreements which will adversely affect its exempt status.

---

## **TRA and Form 8038**

The TRA may include the following representations of the issuer and/or conduit borrower regarding information to be included on Form 8038:

- issue price,
- stated redemption price at maturity of the final maturity of the bonds,
- issue price and the stated redemption price at maturity of the entire issue,
- yield and the net interest cost of the entire issue,
- interest rate of the final maturity, and
- information regarding the refunded bonds, if applicable.

Because this information is provided on Form 8038 which is filed by the issuer, it does NOT have to be included in the TRA.

---

## **TRA and Rebate**

Although a separate arbitrage certificate may be executed, the TRA may also include representations regarding rebate and arbitrage.

The agent should confirm that the issuer and the conduit borrower complied with all of their representations and warranties stated in the TRA, and if all of the requirements of the Code and regulations were met. The TRA may assist in asking the appropriate questions.

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*Continued on next page*

## Offering Documents, Continued

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### **Arbitrage Certificate**

The arbitrage certificate is also called the “No Arbitrage Certificate,” “Certification as to Arbitrage,” or “Tax Certificate.” It is usually prepared by the bond counsel or special tax counsel.

The arbitrage certificate contains factual representations that are the basis for the legal opinion that interest on the bonds is excluded from gross income under IRC § 103.

The arbitrage certificate provides:

- representations of the issuer and conduit borrower (if any) regarding the use of bond proceeds,
  - representations concerning time table for spending bond proceeds, if a construction project,
  - rebate instructions,
  - directions to the bond trustee concerning investment of moneys held in various funds and accounts in the indenture, AND
  - yield on the bonds.
- 

### **Certificate of Issuer’s Expectations for Bonds Issued After 6/30/93**

Treas. Reg. § 1.148-2(b)(2), which is generally applicable to bonds issued after June 30, 1993, provides that an officer of the issuer must certify the issuer’s reasonable expectations as of the issuance date.

The regulations provide that the Certificate of the Issuer’s Expectations is evidence of the issuer’s expectations, but does NOT establish conclusions of law or presumptions. It does not establish the reasonableness of the issuer’s expectations.

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### **Audit Suggestion**

The use of bond proceeds in the arbitrage certificate should conform with the indenture. If it does not, the agent should find out which numbers are accurate. The agent should verify whether bond proceeds were spent as stated in this document.

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*Continued on next page*

## Offering Documents, Continued

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### TEFRA Requirement

If the bonds under examination are qualified private activity bonds, the agent should review the resolutions of the issuer regarding the TEFRA Hearing and TEFRA Notice.

Under IRC § 147(f), special public approval requirements apply to qualified private activity bonds:

- before the issue date, the issuer must approve the bond issue after a public hearing, AND
  - reasonable public notice must be provided prior to the hearing.
- 

### Trust Indenture

Most bonds are issued pursuant to a trust indenture. In certain instances, bonds are issued pursuant to the bond resolution of the issuer. If so, the issuer appoints the bond trustee pursuant to the resolution.

The indenture is a contract between the issuer and the bond trustee, and sets forth the obligations of the issuer to the bondholders.

The types of bonds and the structure of the financing can be determined from the indenture and the bond resolution.

---

### Information in the Indenture

The indenture commonly provides:

- terms of the bond, such as interest rate(s), redemption provisions, maturity schedule,
- purpose for which bonds are issued,
- sources of payment for the bonds,
- security for the bonds,
- whether the issuer has obtained credit enhancement for the bonds, such as bond insurance, letter of credit, collateral agreement, or guaranty by third party,
- requirements to be met by issuer or conduit borrower before the trustee can release bond proceeds,
- obligations and covenants of the issuer,
- events of and remedies for default,
- duties and obligations of the bond trustee, AND
- funds and accounts created under the indenture and amount of bond proceeds and other money deposited in those funds and accounts.

These funds and accounts created under the indenture are discussed next.

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# Basic Legal Documents

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## **Bond Purchase Agreement**

The bond purchase agreement is an agreement between the issuer and the underwriter of the bonds regarding the sale of the bonds to the underwriter.

In a conduit financing, the conduit borrower is also a party to the bond purchase agreement.

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## **Loan Agreement**

The conduit borrower borrows the proceeds of the bonds pursuant to a loan agreement which contains the obligations of the conduit borrower.

An installment agreement may exist between the issuer and conduit borrower. In this case, the issuer owns the project and the conduit borrower has use of the project and will purchase it from the issuer over the term of the bonds.

The loan payments required by the conduit borrower are paid to the trustee to make the principal and interest payments on the bonds.

---

## **Lease Agreement**

Under some state laws, the issuer is not authorized to LOAN bond proceeds, but is authorized to LEASE the project to the conduit borrower. In these cases, the issuer acquires the project and immediately leases it the conduit borrower for the term of the bonds. At the end of the lease term, the conduit borrower becomes the owner of the project. In this case the bond transcript will have a lease agreement rather than a loan agreement.

The lease payments required by the conduit borrower are paid to the trustee to make the principal and interest payments on the bonds.

---

## **Escrow Agreement (Advance Refundings Only)**

An escrow agreement is completed for an advance refunding bond issue only. In the agreement the issuer directs an escrow agent (usually the bond trustee) to hold and invest bond proceeds to pay off the refunded bonds.

The bond proceeds are required to be invested at or below the yield on the refunding bonds.

Amounts in the escrow fund could be used to pay normal debt service on the refunded bonds for several years until a future call date when either all or a significant amount of the refunded bonds outstanding can be redeemed.

---

## Funds Created Under the Indenture

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### **Funds and Accounts Created Under Indenture**

Funds and accounts created under the indenture can include:

- construction fund, or other fund where majority of bond proceeds are deposited,
- debt service fund,
- reasonably required reserve fund,
- cost of issuance fund, and
- rebate fund.

These funds are discussed below.

---

### **Construction Fund**

Each indenture establishes a fund into which a majority of bond proceeds are deposited on the date of issuance. The moneys in this fund are used to achieve the purposes for which the bonds were issued.

The fund may be called any of the following:

- construction fund,
- acquisition fund,
- proceeds funds,
- refunding fund, or
- other.

If the bonds were issued for construction purposes, the indenture directs the trustee to invest the moneys in the construction fund and to permit withdrawals from the fund as needed.

If bond proceeds are used to refund prior bonds, the trustee is instructed to transfer the moneys to the trustee for the refunded bonds or an escrow agent, and invest the moneys until the redemption date of the refunded bonds.

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*Continued on next page*



## Funds Created Under the Indenture, Continued

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**Debt Service Fund**

Each indenture establishes a fund to deposit revenues used to pay debt service on the bonds.

The fund may be called any of the following:

- debt service fund,
- bond fund,
- revenue fund, or
- something equivalent.

Revenues to pay debt service on the bonds can come from a variety of sources.

---

**Reasonably Required Reserve or Replacement Fund**

If the issuer has determined that a reasonably required reserve or replacement fund is necessary, the indenture establishes such fund and instructs the trustee to deposit the required amounts into the fund.

The reserve fund requirement is determined on the date of issuance of bonds.

The reserve fund may be funded with:

- bond proceeds,
  - other money of the issuer, or
  - a surety bond.
- 

**Cost of Issuance Fund**

The indenture may establish a cost of issuance fund to pay costs of issuing the bonds. The amounts deposited in the fund may or may not be bond proceeds.

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**Rebate Fund**

Most indentures establish a rebate fund into which the issuer or conduit borrower must deposit amounts to pay rebate to the United States Treasury.

However, there are no requirements that a rebate fund must be established.

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# Securities Regulations

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## **Federal Securities Law**

Under federal securities laws, tax-exempt bonds are exempt from registration. However, certain rules under federal securities laws are applicable to the bonds.

The federal securities laws require that the draft and final offering documents be true and correct and not contain any statement that is misleading. The offering documents should also NOT OMIT any information that causes the documents to be misleading.

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## **Blue-Sky Laws**

The underwriter is required to meet certain rules under state securities laws, called “blue-sky laws.”

If the underwriter solicits sales in a particular state, the blue-sky laws of that state must be followed. A blue-sky memorandum is often included in the bond transcript. This is evidence that the underwriter and its counsel surveyed the blue-sky laws of the states in which solicitations were made, or are expected to be made.

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## Costs of Issuing the Bonds

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The issuer incurs certain costs in connection with issuing the bonds. These costs are similar to financing costs incurred by a person in obtaining financing for a home.

The costs include fees for individual services, such as:

- counsel to various parties,
- underwriter,
- financial advisor,
- trustee, AND
- rating agencies.

Costs also include direct out-of-pocket expenses, such as:

- printing fees for the offering document,
- travel expenses for the various parties, AND
- copying charges.

Cost of issuance is defined in Treas. Reg. § 1.150-1(b).

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## Summary of Module A

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### **Review**

Module A provided a basic understanding of the municipal bond market. It introduced specialized terms and documents used in the bond market, and explained the mechanics of a bond issue.

The basic bond documents prepared on the issuance date are included in a bond transcript. Review of the bond transcript will be the first step in any examination. Although the transcript shows how the financing arrangement was supposed to work, it will not contain any records to show exactly how the proceeds were used. These records must be obtained from the issuer, trustee, or conduit borrower.

The information presented in this module is important because the terms and concepts will be referred to throughout the remainder of the course.

Refer to the Glossary at the end of this text for quick access to the definitions of the terms and concepts used in this module.

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### **Preview of Module B**

Module B provides an introduction to the federal taxation of municipal bonds. This introduction focuses on IRC § 103 and its relationship with sections 141-150. It will give you a map for your audit plan, and also provide an overview of the entire course.

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# Case Studies

## Case Study #1

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### Case Study #1 Facts

State wants to issue bonds for the purpose of constructing a portion of a state highway. State hires Corporation A to underwrite the bonds and sell them to investors. The potential bondholders will purchase the bonds only if a law firm nationally recognized in the area of municipal bonds gives an opinion that the bonds are validly issued and interest on the bonds is exempt from federal income taxation. The State therefore retains Law Firm X to prepare the documents and render the required opinion. The State and Corporation A determine that approximately \$41 million principal amount of bonds will be needed to finance the state highway. Corporation A needs an official statement which describes the transaction, the State, and the financial condition of the State. Corporation A will use the official statement to solicit future bond purchasers. Corporation A retains Law Firm Y to assist it in preparing the prospectus and to meet various requirements under federal and state securities laws.

The payment of the principal of and interest on the bonds will be secured by the full faith and credit and taxing power of the State. The State had the bond issue approved by the voters pursuant to a bond referendum. The State wants a level debt service for the term of the bonds. State also wants to pay principal of and interest on the bonds at least 15 days after it receives an influx of tax revenues from its residents.

The State adopts a resolution authorizing the issuance of the bonds. The resolution also provides the amount of debt service on the bonds and the payment schedule. The resolution authorizes the State to enter into a bond purchase agreement with Corporation A pursuant to which it will sell the bonds to Corporation A. Corporation A uses the preliminary official statement to solicit bond purchasers.

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## Case Study #1, Continued

### Case Study #1 Facts (continued)

State is in good financial condition and its long-term debt is rated “AAA” by Agency D and “Aaa” by Agency F. State and Corporation A agree that the bonds will sell at a lower interest rate if the State, based upon its financial standing receives letters from Agencies D and F that the bonds will be rated “AAA” and “Aaa.” To be able to obtain these letters, the State provides Agencies D and F with a draft of the resolution, the latest audited financial statements of the State, and its unaudited financials for the last quarter. Based upon these documents, both Agency D and Agency F notify the State that on the date of issuance of the bonds, they will provide a letter that will state that the bonds are rated “AAA” and “Aaa” respectively.

Corporation A uses the preliminary official statement to solicit bids by potential purchasers of the bonds. It is able to get purchasers for all of the bonds on June 7. On the same day, Corporation A notifies the State of the proposed sale. The state is pleased with the terms at which Corporation A has sold the bonds to the purchasers. The State enters into the bond purchase agreement with Corporation A on June 7. The agreement provides that if all conditions are met, the State will issue the bonds in the principal amount of \$41M on June 16. The agreement and the resolution provide that the bonds are dated June 1 and the bonds will have the maturities listed in the Table below:

Year of Maturity	Principal Amount	Interest Rate
1998	\$ 500,000	4.45%
1999	550,000	4.70
2000	600,000	4.85
2001	625,000	4.95
2002	675,000	5.05
2003	700,000	5.20
2004	800,000	5.30
2005	850,000	5.40
2006	905,000	5.50
2007	1,000,000	5.60
2012	6,000,000	6.25
2017	12,750,000	6.50
2023	15,045,000	6.75

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## Case Study #1, Continued

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### Case Study #1 Facts (continued)

The agreement also provides that on June 16, upon receiving the purchase price from Corporation A, the state will deliver the bonds to Corporation A. Between June 7 and June 16, Law Firms X and Y finalize the documents, including the preparation of the final office statement. The Corporation A receives CUSIP numbers for each maturity of the bonds. Law Firm X prepares the bonds and the representative of the State authorized to do so, executes and seals each bond.

On June 15, the bonds are delivered to the Depository Trust Company (DTC), for the account of Corporation A by the State. On June 15, the representatives of the State, Corporation A, Law Firm X, and Law Firm Y meet at the offices of Law Firm X to review all of the documents and to determine that all things necessary for the delivery of the bonds have occurred. There are many documents on the table, some of which are:

- the resolutions of the State,
- the bond purchase agreement,
- the preliminary and final official statements,
- copies of the bonds which were sent to DTC,
- an opinion of Law firm X that the interest on the bonds is exempt from federal income tax,
- the opinion of Law Firm Y that the official statement is true and correct and does not contain any misleading statements, AND
- letters from Agency D and Agency F stating that the bonds are rated “AAA” and “Aaa.”

On June 16, the parties meet at the offices of Law Firm X and after a last review, Corporation A wires to the treasurer of the State \$40,828,000. The State and Corporation A call DTC, and at the request of the State, DTC releases the bonds to Corporation A. Corporation A signs a receipt that it has received the bonds. The State signs a receipt that it has received \$40,828,000. This amount consists of:

Principal amount	\$41,000,000
Corp A discount	< 410,000>
Accrued interest *	<u>238,000</u>
Net Proceeds	\$40,828,000

\*from June 15, their dated date, to June 16, the issuance date.

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## Case Study #1, Continued

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**Case Study #1  
Facts**  
(continued)

The deal is closed.

Law Firm X submits a bill to the State and receives a check in the amount of \$50,000. Law Firm Y is paid by the Corporation A. State also mails a check to the rating agencies in the total amount of \$30,000. The State also reimburses Corporation A for its out-of-pocket expenses in the amount of \$35,000 for printing the official statement and obtaining CUSIP numbers, etc.

Sometime in the near future, Law firm X will prepare the transcript for the transaction which will include all of the documents on the table at the time of the closing. Law firm X will deliver the bond transcript to all of the parties.

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**Note**

CUSIP is an acronym for “Committee for Uniform Securities Identification Procedure.” Each maturity in a bond issue has its own CUSIP number. The CUSIP number consists of a total of nine numbers and letters. CUSIP numbers provide complete, unique identification of a bond.

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**Question 1**

Identify the following:

- parties to the transaction,
- type of bond,
- structure of the bonds,
- costs to the issuer, AND
- ratings applicable to the bonds.

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## Case Study #1, Continued

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### Question 2

Assume that the highway constructed in Case Study #1 is a toll road and the debt service on the bonds will be paid solely by the tolls received from the users of the road. The State has not pledged its full faith and credit and did not have a voter referendum.

Identify the type of bonds.

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### Question 3

Assume that the road to be constructed services a new subdivision to be developed. The State has agreed with the developer of the subdivision that the bond proceeds can be used to construct the road as long as the State's general taxes will not pay debt service on the bonds. The State agrees to assess special charges on the homeowners in the subdivision. The charges will be assessed on each homeowner based upon the homeowner's frontage.

Identify the type of bonds.

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## Case Study #1, Continued

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### Question 4

Assume that the interest rate on the bonds is determined every first Monday of the month. The bondholders have the right to tender the bonds on the interest rate determination date.

What type of interest rate do the bonds bear?

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### Question 5

Assume that the bonds are issued as variable rate bonds. The State enters into an agreement with Bank D to purchase bonds that are not remarketed on a tender date.

Is Bank D a credit enhancer or liquidity provider?

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## Case Study #2

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### Case Study #2 Facts

Hospital is an organization described in IRC § 501(c)(3). It has been in business in the County for many years and has sound finances. There is a small community hospital in the county which is having financial difficulties. The community hospital is needed to serve the residents of the County. The board of directors of the Hospital determines that it could purchase the community hospital and, with better management, make it financially viable. The Hospital determines that using proceeds of tax-exempt bonds would be the best method for financing the purchase.

The Hospital files an application with the Industrial Development Authority of the County (“the Authority”) and requests that the Authority issue \$50M principal amount of bonds. The Authority agrees to issue the bonds and to loan the proceeds of the bonds to the Hospital. The Authority has on retainer Law Firm X which advises the Authority on all legal matters. Although Law Firm X is a well known local firm and proficient in issues of state law affecting the Authority, it is not a nationally recognized law firm which has given an opinion on the tax-exempt status of municipal bonds. For purposes of bond issues, Authority retains Law Firm Y, a nationally recognized bond counsel.

On the date the bonds are issued, the Authority will loan the proceeds of the bonds to Hospital. Hospital retains Law Firm Z to provide legal advice in connection with the financing. Law Firm Z will also be required to render an opinion that the Hospital is an organization described in IRC § 501(c)(3).

The Authority is an active issuer in the County and to advise it on financial matters, it has a three-year retainer with Corporation A. Corporation A is a national investment banking firm and an underwriter of municipal bonds. Corporation A does not, during the term of its retainer, underwrite the Authority’s bonds. Hospital, Authority, and Corporation A agree to retain Corporations B and C to underwrite the bonds. Corporation B, a national investment banking firm, would be the lead underwriter and Corporation C, a regional investment banking firm, will concentrate on selling the bonds in the local market. Corporations B and C retain Law firm W.

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## Case Study #2, Continued

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**Case Study #2  
Facts  
(continued)**

The Hospital, on a regular basis, submits its audited financial statements and other information to one rating agency, and its long-term debt rating is currently “BBB.” Based upon their experience and the Hospital’s credit rating, Corporations A, B, and C believe that the bonds would probably have an average interest cost of 10 percent. Corporation A advises the Authority that because of the Hospital’s rating, it should require the Hospital to obtain bond insurance. Corporations B and C advise Hospital that it could substantially reduce its debt service on the bonds if the bonds were credit enhanced and rated “A+” or above.

Hospital and Corporations B and C negotiate with Insurer regarding the insurance on the bonds. After reviewing Hospital’s financial information, the Insurer agrees to insure the bonds for a premium equal to 1 percent of the principal amount of the bonds issued. The Insurer will also require financial and other covenants from the Hospital.

The Authority and Hospital agree that a local bank will act as the trustee (“the Trustee”) for the bondholders.

Corporations A, B, C, and the Hospital agree that because of the large difference between variable rates and fixed rates, it would be financially prudent for Hospital if the bonds initially bear interest that is determined on a weekly basis. Hospital wants to pay interest on the bonds on the first business day of each month. Hospital wants to be able to pay off a portion of the bonds at any time that it has additional cash.

Hospital retains Corporation B to remarket the bonds which are tendered by their owners. The interest rate on the bonds will be determined on each Tuesday. The bonds will bear that rate from the following Wednesday to the next Tuesday. The bonds will be subject to tender by the bondholders on each Wednesday. Hospital decides that instead of insuring the bonds, it should obtain a letter of credit from Bank Z. Bank Z’s long-term debt rating is rated “A+” by one of the rating agencies. Bank Z will also purchase bonds tendered by the bondholders that have not been remarketed.

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## Case Study #2, Continued

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### Case Study #2 Facts (continued)

Law Firm Y has the primary responsibility of drafting the basic bond documents, such as the indenture, loan agreement, tax certificate, resolutions of the Authority and closing certificates. Law Firm W has the primary responsibility of drafting the preliminary and final offering documents and preparing the blue-sky survey.

Corporations B and C use the preliminary offering document to solicit bond purchasers. On April 11 Corporations B and C inform Hospital and the Authority that the bonds have been sold, but the interest rate on the bonds will be determined on the date of issuance. All parties to the transaction agree that the interest rate(s) on the bonds are acceptable. Hospital, the Authority, Corporations B and C agree that delivery of the bonds to the purchasers will be made on April 14. On April 11, the Authority, Hospital, and Corporations B and C execute the bond purchase agreement.

The bond purchase agreement provides that on April 14, Corporation B, as the lead underwriter, will wire the purchase price for the bonds (less the underwriter's discount to be paid to Corporations B and C) to the Trustee. At the same time, the bonds will be delivered to DTC for the account of Corporation B. Trustee will wire the letter of credit fees to Bank Z and Bank Z will issue a letter of credit to the Trustee. The bond purchase agreement states that the underwriter's discount for the bonds is \$400,000.

On April 13, the Corporation determines that starting April 14 to the next Tuesday, the interest rate on the bonds will be three percent. Trustee receives \$49,600,000, which is the principal amount of the bonds, \$50M, less the underwriter's discount of \$400,000. The up-front fee for the letter of credit is \$250,000. The Trustee also pays the following fees and expenses:

Law Firm X.....	\$15,000
Law Firm Y.....	60,000
Law Firm Z.....	30,000
Law Firm W.....	30,000
Out-of-pocket expenses of underwriters.....	27,000
Fees of the rating agency.....	15,000
Fees of the Trustee.....	3,000
Fees to Bank Z.....	250,000

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## Case Study #2, Continued

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**Question #1**

Identify the following:

- parties to the transaction,
- type of bond,
- structure of the bond,
- costs to the issuer, AND
- the ratings applicable to the bonds.

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## Case Study #2, Continued

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**Question #2**

Assume that after the letter of credit expires, the Hospital decided not to get a new letter of credit. It instead remarkets the bonds as fixed rate bonds. On the date of remarketing of the bonds as fixed rate bonds, the Hospital's rating was "BBB."

What will be the rating on the bonds?

What else can the Hospital do?

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## Case Study #3

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### Case Study #3 Facts

University is an organization described in IRC § 501(c)(3).

Hospital is also an organization described in IRC § 501(c)(3).

The University and the Hospital are controlled by System, an organization described in IRC §§ 501(c)(3) and 509(a)(3).

The Hospital and University are located in the State of Garfield. The Hospital and the University have numerous campuses located in Campbell, the largest city in the State of Garfield and the surrounding jurisdictions.

At the request of System, the Industrial Development Authority of the City of Campbell (the “IDA”) issues \$47,865,000 principal amount of bonds (the “Bonds”) and loans the proceeds of the Bonds to the System. The System uses the proceeds to acquire and renovate the parking lots. The Bonds are secured by the general revenues of the system, as are the \$50M principal amount of bonds issued by the Economic Development Authority of the State of Garfield for the System in 1990 (the “1990 Bonds”), and the \$10M principal amount of bonds issued by the IDA in 1991 (the “1991 Bonds.”)

The 1990 Bonds and the 1991 bonds were insured by Corporation X. Corporation X also insures the Bonds. The System uses \$478,650 of the proceeds of the Bonds to pay Corporation X as a premium for the bond insurance policy.

The System is advised regarding financial matters, such as investment of its endowment fund and other funds by Corporation Y. Corporation Y also advises the System in the borrowing of the proceeds of the Bonds.

The IDA has a three-year contract with Corporation Z to advise it in matters relating to issuance of bonds. Corporation Z recommends to the IDA that the IDA hire Corporation M to offer the Bonds to the public at the time of the sale of the Bonds. Corporation M charges a fee equal to 0.75% of the principal amount of the Bonds. Out of that fee it pays Law Firm A the amount of \$30,000 to provide it with advice regarding Federal and state securities laws.

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## Case Study #3, Continued

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**Case Study #3  
Facts  
(continued)**

IDA, with the agreement of System, retains Law Firm B to prepare the basic bond documents and to make certain that the requirements of IRC § 141 through 150 are met with regard to the issuance and sale of the Bonds. Law Firm B will also render an opinion that the interest on the Bonds will be excluded from gross income of the owners of the Bonds from Federal income tax purposes. Law Firm B will be paid \$50,000 from the proceeds of the Bonds.

On the date of issuance of the Bonds, IDA executes and delivers an indenture of trust with Bank C. The indenture of trust provides the terms of the Bonds and states, among other things, the rights and remedies of the bondholders in the event that the Bonds are in default. Bank C will receive an up-front fee of \$5,000 in connection with the financing.

Law Firm D has been System's counsel for a number of years and advises System on general legal matters. Law Firm D will review all the contracts to be signed by System in connection with borrowing the Bond proceeds. It will also render an opinion regarding the System's corporate ability to borrow the proceeds of the Bonds and System's status as a tax exempt organization under IRC § 501(a). It will receive \$25,000 in connection with the financing.

Because Corporation X will insure the Bonds, they will be rated "AAA" and "Aaa" by Agencies D and E respectively. As a condition of providing bond insurance, Corporation X requires that System obtain a letter from each of Agencies D and E regarding the rating on the Bonds. System will have to pay \$15,000 to each of Agencies D and E.

The IDA tells Corporation M that it has a contract with a printer in town to print and distribute the offering documents. The printer will charge \$27,500 for printing the preliminary and final offering documents and mailing these to the parties requested by Corporation M.

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## Case Study #3, Continued

**Case Study #3  
Facts  
(continued)**

The IDA, the System, and Corporation M execute a bond purchase agreement on November 3. The bond purchase agreement provides that the bonds will have the following maturities:

Due Date	Amount Maturing	Interest Rate
1990	\$1,050,000	5.90%
1991	1,035,000	6.00
1992	1,095,000	6.10
1993	1,165,000	6.20
1994	2,815,000	6.30
1995	2,860,000	6.40
1996	4,605,000	6.50
1997	4,600,000	6.55
1998	4,095,000	6.60
1999	4,115,000	6.70
2000	4,135,000	6.75
2001	4,165,000	6.875
2005	12,130,000	7.75

The bond maturing on 2005 will be paid as follows:

Year	Amount
2002	\$4,310,000
2003	3,420,000
2004	2,125,000
2005	2,275,000

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## Case Study #3, Continued

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**Question #1**

Identify the following:

- the parties to the transaction,
- the type of bond,
- the structure of the financing,
- the serial and term bonds, AND
- the cost of issuing the bonds.